No. 80-338

In the Supreme Court of the United States

OCTOBER TERM, 1980

HCSC-LAUNDRY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether a corporation operated by several tax-exempt charitable hospitals for the purpose of providing hospital laundry and linen supply services is itself a tax-exempt charitable organization under Section 501(c)(3) of the Internal Revenue Code of 1954.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statutes and regulations involved	1
Statement	1
Discussion	4
Conclusion	10
Appendix	1a

TABLE OF AUTHORITIES

Cases:

Associated Hospital Services, Inc. v. *Commissioner*, 74 T.C. 213, pending on appeal, No. 80-3596 (5th Cir.)	8, 9
Bulova Watch Co. v. *United States*, 365 U.S. 753	5
Chart, Inc. v. *United States*, 491 F. Supp. 10, pending on appeal, Nos. 80-1138, 80-1139 (D.C. Cir.)	7
Commissioner v. *Kowalski*, 434 U.S. 77	4
Community Hospital Services, Inc. v. *United States*, 79-1 U.S.T.C. ¶ 9301, pending on appeal, No. 79-1286 (6th Cir.)	7
Hospital Bureau of Standard & Sup. v. *United States*, 158 F. Supp. 560	5, 8
Hospital Central Services Ass'n v. *United States*, 623 F. 2d 611	7, 8
Metropolitan Detroit Area Hospital Services v. *United States*, 445 F. Supp. 857, pending on appeal, Nos. 78-1205, 78-1218 (6th Cir.)	7
National Muffler Dealers Assn. v. *United States*, 440 U.S. 472	
Northern California Central Services, Inc. v. *United States*, 591 F. 2d 620	7, 8, 9
United Hospital Services, Inc. v. *United States*, 384 F. Supp. 776	7

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Statutes and regulations: Page

Internal Revenue Code of 1954 (26 U.S.C.):

Section 1 4
Section 11 4
Section 61(a) 4
Section 501(a) 1, 4
Section 501(c) 1, 4
Section 501(c)(3) 2-3, 4, 5, 7, 8
Section 501(e) 1, 3, 4, 5, 6, 7, 8
Section 502 ..... 5, 8, 1a
Section 502(a) 1, 1a

Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, Section 109(a), 82 Stat. 251.. 6
26 U.S.C. 7428 9
Treasury Regulations on Income Tax, Section 1.502-1(b) (26 C.F.R.) 1, 8, 1a

Miscellaneous:

114 Cong. Rec. 7516 (1968) 6
114 Cong. Rec. 8111-8112 (1968) 6
122 Cong. Rec. 25915 (1976) 7
Hearings on Certain Committee Amendments to H.R. 10612 Before the Senate Comm. on Finance, 94th Cong., 2d Sess. (1976) 6
H.R. Conf. Rep. No. 1030, 90th Cong., 1st Sess. (1967) 6
H.R. Conf. Rep. No. 1533, 90th Cong., 2d Sess. (1968) 6
Rev. Rul. 54-305, 1954-2 Cum. Bull. 127 5
S. Rep. No. 744, 90th Cong., 1st Sess. (1967) 6
S. Rep. No. 94-938 (Pt. 2), 94th Cong., 2d Sess. (1976) 7
Staff of Comm. of Conference, 90th Cong., 2d Sess., *Explanation of the Bill H.R. 15414* (Comm. Print 1968) 6
Tax Reform Act of 1975: Hearings on H.R. 10612 Before the Senate Comm. on Finance, 94th Cong., 2d Sess. (1976) 6-7

OPINIONS BELOW

The memorandum and order of the district court (Pet. App. A22-A31) is reported at 473 F. Supp. 250. The opinion of the court of appeals (Pet. App. A1-A19) is reported at 624 F. 2d 428.

JURISDICTION

The judgment of the court of appeals was entered on June 6, 1980 (Pet. App. A20-A21). The petition for a writ of certiorari was filed on September 2, 1980. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant provisions of Sections 501(a), (c) and (e) of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth at Pet. 2-4. The relevant provisions of Section 502(a) of the Internal Revenue Code of 1954 (26 U.S.C.) and of Section 1.502-1(b) of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) are set forth at Appendix, *infra*, 1a-2a.

STATEMENT

Petitioner is a corporation organized under the Pennsylvania Nonprofit Corporation Law "[t]o operate and maintain a hospital laundry and linen supply program for those public hospitals and non-profit hospitals or related health facilities organized and operated exclusively for religious, charitable, scientific, or educational purposes that contract with [it]" (Pet. App. A3 & n.1). Petitioner provided laundry and linen service to 15 nonprofit hospitals located in the Greater Lehigh Valley, Reading, Scranton, and

suburban Philadelphia, Pennsylvania, and to the Cetronia Ambulance Corps. Petitioner has no capital stock. Each participating hospital paid $500 as membership dues to petitioner for the taxable year at issue. Cetronia Ambulance Corps paid no membership dues to receive petitioner's laundry service. Apart from the membership dues, petitioner's only income is derived from a charge of 1½ cents per pound of laundry serviced paid by each customer in addition to petitioner's actual cost. For this purpose, "cost" includes operating expenses, debt retirement, and linen replacement. The amounts petitioner charged for laundry service in excess of its cost were placed in a fund for equipment replacement and acquisition (Pet. App. A3, A5).

No part of petitioner's net earnings inures to the benefit of any individual (Pet. App. A6-A7).

Petitioner was formed after the Lehigh Valley and Health Planning Council determined that a shared nonprofit, off-premises laundry would best accommodate the requirements of the member hospitals both from the viewpoint of quality of service and economies of scale. At the time the Council made this determination, a commercial laundry had rejected the offer to take on the full volume of laundry business of all the hospitals involved. Most of the other available commercial laundries were not capable of managing the heavy volume of the hospitals (Pet. App. A3-A5).

Petitioner's laundry plant was built and equipped at a cost of approximately $2 million, which it borrowed from local banks by using as collateral 15-year contracts from ten area hospitals. Petitioner employs approximately 125 persons (Pet. App. A5).

On March 26, 1976, petitioner applied for exemption from federal income taxation under Section 501

(c)(3) of the Internal Revenue Code. This section authorizes exemption for corporations "organized and operated exclusively for religious, charitable, scientific, * * * or educational purposes, * * * no part of the net earnings of which inures to the benefit of any private shareholder or individual * * *." On June 21, 1976, the Internal Revenue Service rejected petitioner's application on the ground that Section 501(e) of the Internal Revenue Code was the exclusive provision under which shared hospital service organizations could be classified as an organization "organized and operated exclusively for charitable purposes" and that shared hospital service organizations providing laundry service were not included in Section 501(e) (Pet. App. A5-A8, A23).

On December 16, 1976, petitioner filed its federal corporate income tax return for its taxable year ended June 30, 1976, on which it reported taxable income of $123,521 and paid a tax of $10,395. Shortly thereafter, petitioner filed a claim for refund of the taxes paid for this fiscal year (Pet. App. A23-A24).

After the Internal Revenue Service took no action on its claim for refund within six months, petitioner commenced this refund suit in the United States District Court for the Eastern District of Pennsylvania (Pet. App. A8). The district court held that petitioner was entitled to exemption as an organization described in Section 501(c)(3) and entered summary judgment for it (Pet. App. A22-A31).

The court of appeals reversed. It concluded that Section 501(e) was the exclusive provision under which cooperative hospital service organizations could obtain tax exemptions and that the omission of laundry services from the enumerated list of activities of such cooperative service organizations showed that

Congress intended to exclude cooperative hospital laundries from tax exempt status (Pet. App. A1-A21).

DISCUSSION

1. The decision below correctly held that cooperative hospital laundry service corporations such as petitioner are not exempt from tax under Section 501(c)(3) of the Code.

It is a fundamental principle of our income tax system that absent a specific statutory exception, the gross income of all persons, natural or corporate, is subject to tax. See Sections 1, 11, 61(a) of the Code (26 U.S.C.); *Commissioner* v. *Kowalski*, 434 U.S. 77, 82-83 (1977). One of the exceptions to this general rule is Section 501(a) of the Internal Revenue Code of 1954 (Pet. 2), which exempts the income of organizations described in Section 501(c) (Pet. 2-3). Organizations exempt under Section 501(c)(3) include "[c]orporations * * * organized and operated exclusively for * * * charitable * * * purposes * * * no part of the net earnings of which inures to the benefit of any private shareholder or individual * * *."

Section 501(e) specifically deals with the tax-exempt "charitable" status of specified mutual enterprises owned and operated by and for tax-exempt hospitals (see Pet. 3-4). It provides in pertinent part that a shared hospital service corporation will be treated as an organization described in Section 501(c)(3) if it provides certain specific services to certain tax-exempt hospitals and meets other qualifications. However, laundry service is not included in the enumerated statutory list.

The absence of laundry services from the detailed list of activities that a hospital service corporation

can provide and maintain tax-exempt status supports the conclusion of the court below that in enacting Section 501(e), Congress intended to exclude any other means by which shared hospital services organizations might qualify for exemption. That section lists the specific types of services which can be performed by qualifying organizations and sets out the precise organizational criteria they must satisfy. It is a basic principle of statutory construction, particularly with regard to tax cases, that a specific statute controls over a general provision. *Bulova Watch Co.* v. *United States*, 365 U.S. 753, 761 (1961). Here, Section 501(e) specifically addresses jointly operated hospital service organizations. Since shared hospital service organizations providing laundry services are not included in Section 501(e), they are not entitled to tax-exempt status under Section 501(c)(3).

As the court of appeals pointed out (Pet. App. A12-A16), the legislative history confirms that Congress intended Section 501(e) to be controlling. Prior to consideration of the specific problem of tax-exempt status of shared hospital service organizations, the law was uncertain. In accordance with the pertinent Treasury Regulations, the Internal Revenue Service took the position that if two or more tax exempt hospitals created an entity to perform ordinary commercial services for them, the entity was a so-called "feeder organization" under Section 502 of the Code (Appendix, *infra*, 1a) and would not be entitled to tax-exempt status. Rev. Rul. 54-305, 1954-2 Cum. Bull. 127. The Court of Claims, however, rejected this position in *Hospital Bureau of Standard & Sup.* v. *United States*, 158 F. Supp. 560 (1958). After

expressly noting the uncertainty in the law,[1] Congress enacted Section 501(e) in 1968. See Section 109(a), Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, 82 Stat. 251.

In considering the provisions in the Tax Adjustment Bill of 1968 that ultimately became Section 501(e), the Senate sought to include laundry service among the enumerated list of services that a cooperative hospital corporation could provide and still maintain its tax-exempt status. The Treasury supported the Senate amendment. 114 Cong. Rec. 7516, 8111-8112 (1968). At the urging of commercial laundry interests, however (see *Hearings on Certain Committee Amendments to H.R. 10612 Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 608 (1976), the Conference Committee would accept only a more limited version of the Senate amendment. In recommending the adoption of Section 501(e), the House managers emphasized that shared hospital service organizations performing laundry services were not entitled to tax-exempt status under the new provision. H.R. Conf. Rep. No. 1533, 90th Cong., 2d Sess. 43 (1968); Staff of Comm. of Conference, 90th Cong., 2d Sess. 20, *Explanation of the Bill H.R. 15414* (Comm. Print 1968).

Finally, in 1976, at the urging of the amicus American Hospital Association, the Senate Finance Committee proposed an amendment that would have added laundry organizations to those specified in Section 501(e) (*Tax Reform Act of 1975: Hearings on H.R. 10612 Before the Senate Comm. on Finance*,

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[1] See S. Rep. No. 744, 90th Cong., 1st Sess. 200-201, 318 (1967); H.R. Conf. Rep. No. 1030, 90th Cong., 1st Sess. 73 (1967); 114 Cong. Rec. 7516, 8111-8112 (1968); and, Staff of Comm. of Conference, 90th Cong., 2d Sess. 1, 20, *Explanation of the Bill H.R. 15414* (Comm. Print 1968).

94th Cong., 2d Sess. 2765-2772 (1976); S. Rep. No. 94-938 (Pt. 2), 94th Cong., 2d Sess. 76-77 (1976)). However, the amendment was defeated on the Senate floor (122 Cong. Rec. 25915 (1976)).

2. Accordingly, it is beyond dispute that Section 501(e) specifies the types of hospital service organizations that are encompassed within the scope of Section 501(c)(3) as charitable organizations. Since hospital laundries were deliberately excluded from the enumerated statutory list, the decision below correctly held that petitioner is not entitled to tax-exempt status as a charitable organization. Indeed, to hold otherwise would resuscitate the very statutory amendment in favor of hospital laundries proposed both in 1968 and 1976 which Congress twice rejected. The court of appeals properly refused to flout this clear expression of legislative purpose.

In so holding, the court below acknowledged (Pet. App. A16-A17) that its ruling was squarely in conflict with *Northern California Central Services, Inc.* v. *United States*, 591 F.2d 620 (Ct. Cl. 1979), as with several district court decisions. See *United Hospital Services, Inc.* v. *United States*, 384 F. Supp. 776 (S.D. Ind. 1974); *Community Hospital Services, Inc.* v. *United States*, 79-1 USTC ¶ 9301 (E.D. Mich. 1979), pending on appeal, No. 79-1286 (6th Cir.); *Metropolitan Detroit Area Hospital Services* v. *United States*, 445 F. Supp. 857 (E.D. Mich. 1978), pending on appeal, Nos. 78-1205, 78-1218 (6th Cir.). See also *Chart, Inc.* v. *United States*, 491 F. Supp. 10 (D. D.C. 1979) (cooperative hospital data processing corporation exempt under Section 501(c)(3) whether or not it qualifies under Section 501(e)), pending on appeal, Nos. 80-1138, 80-1139 (D.C. Cir.). On the other hand, in *Hospital Central Services Ass'n* v. *United States*, 623 F.2d 611 (1980), the Ninth Cir-

cuit upheld the Commissioner's reading of Section 501(e) and "agree[d] with the Third Circuit for the reasons stated in its opinion" (623 F.2d at 612). Finally, in *Associated Hospital Services, Inc.* v. *Commissioner*, 74 T.C. 213, 231 (1980), pending on appeal, No. 80-3596 (5th Cir.), the Tax Court ruled that such hospital laundry service corporations are taxable, albeit on the ground that they are profit-making "feeder organizations" under Section 502 and Treasury Regulations, Section 1.502-1(b) (26 C.F.R.), Appendix, *infra*, 1a-2a.

3. The fundamental error in the decision of the Court of Claims in *Northern California Central Services, Inc.* was its failure to recognize that Congress did not accept the gloss that court put upon the predecessor of Section 501(c)(3) in *Hospital Bureau of Standard & Sup.* v. *United States*, *supra*. Rather, after noting the uncertainty in the law (see page 6, *supra*), Congress resolved the disagreement between the Court of Claims and the Internal Revenue Service by establishing a new set of statutory standards in Section 501(e) to deal with the specific problems posed by shared hospital service organizations. Given the deliberate exclusion of mutual laundry corporations from Section 501(e), it blinks at reality to suggest, as the Court of Claims did in *Northern California Central Services, Inc.*, that Congress "may have wished not to encourage cooperative hospital laundries by new tax exemptions, to which commercial laundries made vehement objections, yet to leave such laundries free to obtain from the courts the exemptions that existing law might afford them" (591 F.2d at 624).

In support of this conclusion, the Court of Claims stated that Congress did not include laundries in Section 501(e) because it was too controversial a

matter about which it was not sufficiently informed and thereby determined "to leave such a matter to the courts" (591 F.2d at 624). But as the Tax Court correctly pointed out in *Associated Hospital Services, Inc.* v. *Commissioner, supra,* 74 T.C. at 231, "Congress was indeed well informed on this subject—far better, perhaps, with all of the extended hearings, Committee considerations, and floor debates, than a court of law could be on the basis of an administrative record involving only one single organization." There is accordingly no statutory basis for tax exemption of cooperative hospital laundries.

As matters now stand, hospital laundry service corporations such as petitioner would lose their exemptions in the Third and Ninth Circuits but could retain such status in the Court of Claims. Moreover, resolution of the conflict is important to the proper administration of the revenue laws. We are advised by the Internal Revenue Service that there are currently four cases pending in the Court of Claims presenting the question. There are, moreover, four cases pending in the Fifth, Sixth, and District of Columbia Circuits.

Finally, at the administrative level, during the past four months, the Service has issued seven final adverse determination letters to hospital laundry service corporations and it is accepted that these organizations will seek review of these rulings under the declaratory judgment procedure provided by 26 U.S.C. 7428. Fourteen additional cases are awaiting ruling action by the Service. Given the undisputed conflict of decisions and the administrative importance of the question to the private health care industry, we do not oppose the petition for certiorari.[2]

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[2] In light of the narrow scope of the question presented and the clarity of the legislative history discussed above, the Court may wish to consider summary affirmance.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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* The Solicitor General is disqualified in this case.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

Section 502 FEEDER ORGANIZATIONS.

(a) *General Rule.*—An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.502-1 *Feeder organizations.*

* * * * *

(b) If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent

organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations. For purposes of this paragraph, organizations are related only if they consist of—

(1) A parent organization and one or more of its subsidiary organizations; or

(2) Subsidiary organizations having a common parent organization.

An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities.

* * * * *

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